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No. 80-1562

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

MARINE BANK,

Petitioner,

v.

SAMUEL WEAVER AND ALICE WEAVER,

Respondents.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Third Circuit

BRIEF FOR RESPONDENTS

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STATEMENT OF ISSUES PRESENTED

1. Whether there was a genuine issue of material fact with respect to either the Columbus profit sharing agreement or Weavers' six year certificate of deposit being a security, or involved in a "securities transaction" protected by Rule 10 b-5 of the Security and Exchange Commission or Section 17(a) of the Securities Act of 1933 to preclude summary judgment.

2. Whether this Court, even if it should find no purchase and sale of a security or a "securities transaction" within either the 1933 or 1934 Acts, should remand this case to the District Court so that the District Court can resolve the pendent state claims in accordance with the Order of the Third Circuit Court of Appeals.

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SAMUEL WEAVER AND ALICE WEAVER,

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BRIEF FOR RESPONDENTS

COUNTER STATEMENT OF CASE

Sam and Alice Weaver (hereinafter "Weavers") filed a three count complaint against Marine Bank (hereinafter "Bank") in the United States District Court for the Western District of Pennsylvania. The substance of all Counts related to material misrepresentations made by Marine which induced Weaver to pledge a $50,000.00 Certificate of Deposit to Marine on or about March 17, 1978, in exchange for Weavers receiving the right to share in the profits of a slaughterhouse business known as Columbus Packing Company (hereinafter "Columbus").

Count One claimed that the transaction imposed liability against the Bank under the Securities Exchange Act of 1934 (hereinafter the "1934 Act"), 15 U.S.C. § 78(j)(b), and the Securities and Exchange Commis-

sion's Rule 10 b-5 (hereinafter "Rule 10 b-5"), 17 C.F.R. 240, 10(b)-5 (JA-4).[1] Count Two claimed that the same transaction imposed liability against the Bank for violations of the Pennsylvania Securities Act of 1972, 70 Pa. Stat. Ann. § 31 (1972) (JA-8). Count Three claimed that the Bank was liable to the Weavers for common law fraud and misrepresentation under Pennsylvania law (JA-9).[2]

The District Court granted the Bank's motion for summary judgment and dismissed the Weavers' action holding that there was no purchase or sale of a security within the context of either Rule 10 b-5 or Section 17(a). Without diversity of citizenship, the Court also held that it lacked jurisdiction to hear the merits of the claim.[3] The

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[1] (JA) refers to Joint Appendix filed with this Court.

[2] Within a couple weeks of a scheduled trial, and after extensive discovery by both parties and after Pre-Trial Narrative Statements were filed by both parties, the Bank moved for Summary Judgment under Rule 56 of the Federal Rules of Civil Procedure claiming, in substance, that there was no purchase or sale of a security so as to impose liability under Rule 10 b-5 in favor of the Weavers against the Bank (JA-19). The Weavers filed a written answer (JA-39) to the Bank's motion for summary judgment attaching an affidavit of the Weavers (JA 41-43). The Weavers claimed that genuine issues of material fact as to whether there was a purchase and sale of a security imposing liability in favor of the Weavers against the Bank, not only under Rule 10 b-5 made reference to above, but also under Section 17(a) of the 1933 Securities Act, 15 U.S.C.A. § 77(q), precluded the Court from granting the Bank summary judgment under Rule 56 of F.R.C.P. (JA-39).

[3] To clarify the record, the Weavers moved to amend the original complaint after the Court rendered its Opinion granting the Bank's motion for summary judgment, so that it was clear on the record that Weaver was claiming liability under Rule 10 b-5 and Section 17(a). The Court denied the Weavers' motion to amend the complaint as being "unnecessary" as under Rule 15(a) and (c) of the F.R.C.P.

Court incorporated by reference the legal authorities and position of the Bank set forth in its brief (PA-28).[4]

The District Court also dismissed the state law claims against the Bank under Counts Two and Three. The District Court held that there was no independent jurisdictional basis for these claims and that it did not have pendent jurisdiction over these state law claims once the federal claims were dismissed (PA-27, 28).[5]

In reversing the District Court, the Third Circuit Court of Appeals held that there was genuine issues of material fact as to whether there was a purchase and sale of a security, *either* by the pledge of the Certificate of Deposit or the sale of the agreement from Columbus to share up to 50% of the profits of Columbus, which precluded the District Court from granting summary judgment in the claims premised upon the Federal Securities Act (PA-9, 12). The Third Circuit also held that it was error for the District Court to dismiss the state law claims in Counts Two and Three of the complaint in that the District Court had pendent jurisdiction over these claims as they arose

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All theories of liability advanced by the Weavers, including those theories not set forth in the original complaint but identified in responses to the Bank';s motion for summary judgment were considered and rejected by the Court.

[4] (PA) refers to the Petitioners' Appendix included in the Petition for Certiorari filed with this Court.

[5] Because the thrust of the Bank's motion was directed to the claims under the Federal Securities Acts, the parties never briefed the pendent jurisdiction issue to the District Court. There was no indication on the record that the District Court exercised any type of discretion in deciding whether or not it had pendent jurisdiction over the state law claims or that it considered the issues of similarity between the federal and state law causes of action, judicial economy, etc. in determining whether or not it should exercise pendent jurisdiction over the state law claims.

out of the same operative facts as the claims premised under the Federal Securities Act (PA-12-14); it held, as a matter of judicial economy, that all claims relating to these transactions should be resolved in one proceeding in the federal forum (PA-13).

Columbus was a slaughterhouse and retail meat store operated as a sole proprietorship by Raymond and Barbara Piccirillo and located in Columbus, Pennsylvania, a town closely proximate to the Bank's Corry branch office and to the Weavers' home in Union City. The Bank, between 1976 and 1978, made three separate demand loans to Columbus totaling $33,000.00. The Bank intended to collateralize these loans to Columbus by filing U.C.C. claims against the equipment and other assets of Columbus but because it failed to properly perfect its security interest against Columbus' assets,[6] it did not have a secured position with Columbus as of March 17, 1978.

All three of these loans were overdue on January 16, 1978 and Columbus was not able to make any interest or principal payments on that date or thereafter (CA-247).[7] Additionally, at all material times throughout 1977 and through March 17, 1978, Columbus' checking account at the Bank was continuously in an overdraft position (CA-229, 230, 402). The Bank had been fully aware that Columbus was insolvent and without an adequate capital base from its inception in 1976 (CA-209). The Bank's officers attempted repeatedly to cure the "continuing prob-

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[6] The Uniform Commercial Code, 13 Pa.C.S.A. § 9401 (1980), requires the filings to be made in the county where the equipment is located. The Bank filed in Erie County but not in Warren County, the situs of the equipment.

[7] (CA) refers to Appellant's Appendix filed in the Court of Appeals.

lem" with the overdrawn checking account, without success (CA-424, 425).[8]

Being unable to collect its interest and principal on these three loans and unable to solve the Columbus overdraft problem through normal commercial banking procedures, the Bank became actively involved in persuading Piccirillo to secure an investor for Columbus. Working capital was also sought by way of a loan from the United States Small Business Administration ("S.B.A."). The bank hoped that the loan would correct

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[8] On December 28, 1977, the auditor in charge of fraud control of Marine issued a memo to all Marine officers alerting those officers of the "continuing problem" with the Columbus Packing Company checking account (CA-413). It was reported then that:

"1. Subject: checking account, held at the Corry Office, has appeared on the overdraft report an excessive number of times in the past several months. Details of the account are as follows:

a. Name and Address of Account: Columbus Packing Company, R.D. # Lottsville Road, Columbus, PA

b. Account Number: 1001-3029

c. Account Opened: May 7, 1976

d. Checks Returned: 17 (lifetime of account)

e. Number of times overdrawn: 189 (lifetime of account)

f. Current Balance: $9,345.02 Overdrawn

g. Currently Overdrawn Since: September 20, 1977

This account has been in an overdraft status almost constantly since April, 1977, with an average overdrawn balance of approximately $9,000.

2. I have discussed the account on numerous occasions in the past with Corry management and was advised that an SBA loan was being processed which would resolve the overdraft problem. I further discussed the account with R. Santom, this date, for the first time since he assumed the position of Manager, Corry Area, and was informed that he had discussed the account with R. Ross and T. Doolin and that ways and means to resolve the problem are currently being studied . . ."

the Columbus "overdraft" (See Footnote 8). The S.B.A. denied Columbus' application in September of 1977. Subsequent to the denial, the Bank further advanced $20,000.00 to Columbus, the third of the three loans totaling $33,000.00 (CA-431).

In March, 1978, Sam and Alice Weaver were retired farmers; they had no formal education beyond the eighth grade; they were age 78 and 71, respectively; and since 1976, they conducted a small livestock auction (JA-41). Although they were aware of Columbus because they were in related businesses, they had no interest in making any type of investment in Columbus prior to the Bank's solicitations in February and March, 1978 (CA-306, 310, 311). The Weavers had also previously refused solicitations by Columbus (CA-303).

The Weavers withdrew $50,000.00 from a North East, Pennsylvania bank and on February 28, 1978, purchased a $50,000.00 certificate of deposit ("CD") at the Bank's Corry branch (CA-312).[9] This CD had a maturity date of six years and paid 7-1/2% interest. The Weavers intended to use this CD as a source for working capital in their livestock auction business (JA-41). The Weavers had already been solicited by the Bank to make an investment in Columbus prior to the purchase of the CD on February 28, 1978 (CA-130, 134).

The Bank considered the Weavers as "investors" in Columbus (JA-53), even though their investment would be made through the Bank by way of the pledge of their CD (JA-57). The Bank represented to the Weavers that with the "proper money being invested," the Bank

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[9] The CD purchased by Weavers on February 28, 1978 from the Bank is reproduced and attached to the back of the Brief filed by the American Bankers Association at page 1a.

would "restructure" its loan to Columbus (CA-147). Bank officers handling this transaction considered the amount of Weavers' potential "investment" in Columbus as "$50,000.00" (JA-56).

After frequent personal visits to the Weavers' farm (CA-308), on March 15, 1978, a Bank officer persuaded the Weavers to pledge their $50,000.00 CD in exchange for the Bank's $65,000.00 loan to Columbus on the representation to Weavers that, among other things, Columbus would receive all or substantially all of the $65,000.00 as "working capital" (CA-311; JA-41).[10] At no time prior to March 17, 1978 were the Weavers aware that Columbus was indebted to the Bank or that Columbus had any serious financial problems (CA-309, 312, 325).

On March 17, 1978, the Weavers pledged their CD to the Bank which, in turn, loaned Columbus $65,000.00. Just prior to March 17, 1978, and in consideration for the Weavers' pledge of their CD to the Bank, the Weavers executed a written agreement with Columbus which granted them "50% of the adjusted net profits" of Columbus (CA-319).

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[10] On, and prior to, March 17, 1978, the Bank represented to the Weavers the following: (1) all of the $65,000.00 would be available to Columbus for working capital; (2) there was little risk to the Weavers in making this pledge; (3) the Bank had perfected security interests in Columbus' equipment and accounts receivable; (4) the value of this collateral was substantial enough to protect the Bank *and* the Weavers (CA-310); and (5) the Bank would provide the Weavers with a monthly profit and loss statement of Columbus so that the Weavers could monitor the activities of Columbus (JA-41, 42).

These representations proved untrue and one or all of the representations induced the Weavers to pledge their CD to the Bank in exchange for the right to receive up to 50% of the profits of Columbus (JA-42, 43).

The Bank on March 17, 1978, prior to Columbus receiving any of the $65,000.00 in loan proceeds, paid itself $42,515.37 to cover the $34,756.61 loan plus $7,758.77 overdraft position existing in the Columbus checking account. A substantial portion of the remaining $65,000.00 was distributed by the Bank to trade creditors of Columbus who had given notice of their claims prior to March 17, 1978. Approximately $10,133.06 was made available prior to the satisfaction of the $6,300.00 I.R.S. lien (CA-338, 429) for 1977 payroll tax which Columbus had not paid as of March 17, 1978 (CA-276). This left $3,833.06 available to Columbus for working capital. The Bank was fully aware as of March 17, 1978, that this was an inadequate amount of working capital to keep Columbus in business, as the Bank believed that it would take at least $10,000.00 in working capital to "keep this business going" (CA-217). The Weavers were not aware of this disbursement schedule but if they had been, they would not have pledged their CD (CA-327). The Bank, at the same time, closed the existing Columbus checking account and opened a new account. Thereafter, the Bank refused to honor any more Columbus overdrafts and the Columbus checks were being returned because of insufficient funds (CA-338).

After March 17, 1978, the Weavers began receiving checks of Columbus that were returned for insufficient funds. This was the first that the Weavers were aware of Columbus' financial problems and that the Bank had used all or substantially all of the $65,000.00 to reimburse itself for the past indebtedness of Columbus (CA-338).

The primary beneficiary of the proceeds from the $65,000.00 loan was the Bank in that it: (a) provided a vehicle for the Bank to collateralize its indebtedness with Columbus when it had not been properly collateralized

prior to March 17, 1978; and (b) allowed the Bank to correct the "continuing problem" with the Columbus overdraft. At the time that Marine made the $65,000.00 loan to Columbus, there was no reasonable expectation that Columbus would ever be able to repay the principal and interest on the $65,000.00 loan considering that: (1) Columbus was not able to make the principal and interest payment on the $33,000.00 loans previously made by the Bank; (2) Columbus was insolvent at all material times prior to, and after, March 17, 1978; and (3) Columbus was receiving an inadequate amount of working capital to keep its operation going.

On May 9, 1978, as a consequence of insufficient working capital, Columbus elected to close its business (CA-255). In July of 1978, Columbus filed for bankruptcy in the United States District Court for the Western District of Pennsylvania.

The Bank has refused to return the Weavers' $50,000.00 Certificate of Deposit. Marine has not yet foreclosed on the CD, but concedes that foreclosure is inevitable.[1]

SUMMARY OF ARGUMENT

When reviewing a motion for summary judgment made under Rule 56(c) of the F.R.C.P., a court is obligated to review the entire record and construe the facts in the depositions, exhibits, and supporting affidavits and draw the logical inferences from these facts, most favorable to the non-moving party, in this case, the Weavers. *U.S. ex rel Jones* v. *Rundle,* 453 F.2d 147 (3rd Cir. 1971); *Adickes* v. *Kress & Company,* 398 U.S. 144 (1970).

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[1] See Paragraph 11 of Weavers' Complaint (JA-8) and Marine's Answer (JA-16) admitting Weaver's allegations in the Complaint.

In granting summary judgment, the District Court held that neither the Columbus profit sharing agreement sold to Weaver in early March of 1978 nor a six year bank Certificate of Deposit pledged by Weaver to the Bank on March 17, 1978 were securities protected by the anti-fraud provisions of either of the Federal Securities Acts. The Third Circuit correctly concluded that there were facts which would support a conclusion that the Columbus agreement was either: (1) an "investment contract" within *S.E.C.* v. *Howey,* 328 U.S. 293 (1946); or (2) a "profit sharing agreement" within *S.E.C.* v. *Addison,* 194 F.Supp. 709 (N.D. Tex. 1961); or (3) a "certificate of interest." *See Crowell* v. *Pittsburgh & Lake Erie Railroad Company,* 373 F.Supp. 1303 (E.D. Pa. 1974).

To induce the Weavers to pledge their CD to the Bank, the Bank represented to Weaver, among other things, (see Footnote 10) that the pledge would generate $65,000.00 of working capital for Columbus by way of a loan, and that the Bank had adequate collateral from Columbus as of March 17, 1978 to protect Weavers' pledge. Neither was true. Substantially all of the $65,000.00 generated by this pledge was used by the Bank to pay delinquent loans and an overdraft which Columbus owed the Bank. Whether Marine made these representations with the requisite "scienter," *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976), or whether they were made "in connection with" these transactions were issues not resolved by either the District Court or the Third Circuit Court of Appeals and, therefore, are not before the Court at the present time.

The three requirements of the *Howey* test for an investment contract are established by the facts in this case: (1) The Weavers' pledge of their CD to the Bank could be found to be an investment of money in Columbus, *Hector* v. *Wiens,* 533 F.2d 429 (9th Cir. 1976); (2) Col-

umbus was a "common enterprise" and all vertical and horizontal commonality requirements were satisfied, *Hector* v. *Wiens, supra.*, at 33; *Rochkind* v. *Reynolds Securities, Inc.*, 388 F.Supp. 254 (D. Md. 1975); and (3) the Weavers had an "expectation of profits from the efforts of others" in that the profits to be generated by Columbus were primarily dependent upon Piccirillo, *S.E.C.* v. *Glenn Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973), cert. denied 414 U.S. 82 (1973).

The Bank's knowledge of the Columbus agreement with the Weavers and the Weavers' expectations of profits from Columbus could be inferred from the circumstantial evidence, *Ferguson* v. *Omnimedia, Inc.*, 469 F.2d 194 (1st Cir. 1972). Primary liability could therefore be imposed with respect to the Columbus agreement; secondary liability could be imposed. *Monsen* v. *Consolidated Dressed Beef Company, Inc.*, 579 F.2d 793 (3rd Cir. 1978).

The Third Circuit also correctly concluded that the CD, pledged by the Weavers to the Bank, as consideration for future profits in Columbus and as collateral for a $65,000.00 loan, was a security traded in a securities transaction within the protective scope of the Federal Securities Acts, *United States Housing Foundation* v. *Forman*, 421 U.S. 850, 859, 860 (1975). This six year CD was literally a "note" within the definition of security within the 1933 and 1934 Acts and "evidence of indebtedness" within the definition of the 1933 Act. *Garner* v. *Pearson*, 374 F.Supp. 591 (D. Fla. 1974). A pledge of a security is considered a sale for purposes of these Acts. *Rubin* v. *U.S.*, ___ U.S. ___, 100 S.Ct. 698 (1981).

Authorities relied upon to claim that a CD is not a security within the Federal Securities Acts (*such as Canadian Imperial Bank of Commerce Trust Company* v. *Fing-*

land, 615 F.2d 465 (7th Cir. 1980) and others cited therein) all relate to the initial issuance of a CD where the courts have rejected the contention that the issuance is an "investment contract" within *S.E.C.* v. *Howey,* 328 U.S. 293 (1946). The secondary transfer of a bank CD for a loan providing risk capital with the expectation of profits is controlled by a separate line of cases because a loan providing risk capital with an expectation of profits is considered an "investment contract" or a securities transaction. A secondary sale of a bank CD with additional interest paid thereon as a bonus is a protected security transaction. *Safeway Portland Employees Federal Credit Union* v. *C.H. Wagner & Co., Inc.,* 501 F.2d 1120 (9th Cir. 1974). Loan transactions to revive an insolvent business are securities transactions. *S.E.C.* v. *Continental Commodities Corp.,* 497 F.2d 516 (5th Cir. 1974). Misrepresentations made with respect to the underlying collateral for a loan transaction have also constituted protected securities transactions. *El Khadem* v. *Equity Securities Corp.,* 494 F.2d 1224 (9th Cir. 1974), *cert. denied* 419 U.S. 900 (1974).

The Third Circuit also correctly reversed the District Court's dismissal of the claims premised on Pennsylvania law holding that the District Court had pendent jurisdiction over the state law claims in Weaver's Complaint. The Bank in its petition for certiorari to this Court has not raised the Third Circuit's reversal of the dismissal of the pendent claims under Pennsylvania law. Therefore, that holding is not presently before this Court for consideration. Rule 23(c), Rules of the Supreme Court; *Whirlpool Corp.* v. *Marshall,* 445 U.S. 1 (1980).

Should this Court review the pendent jurisdiction issue on its merits it would find that the Third Circuit correctly concluded that the District Court had pendent jurisdiction to hear the claims premised on Pennsylvania law and

that there were compelling reasons to have this case disposed of in one proceeding in the federal forum, *Rosado* v. *Wyman*, 397 U.S. (1970); *Borror* v. *Sharon Steel Company*, 327 F.2d 165 (3rd Cir. 1964). Even if this Court would conclude that there was no purchase and sale of a security within the Federal Securities Acts, it should remand this case to the District Court for further proceedings consistent with the Opinion of the Third Circuit reversing the District Court's grant of summary judgment in favor of the Bank.

ARGUMENT

I. WHETHER THERE WAS A GENUINE ISSUE OF MATERIAL FACT WITH RESPECT TO EITHER THE COLUMBUS PROFIT SHARING AGREEMENT OR THE WEAVER'S SIX YEAR CERTIFICATE OF DEPOSIT BEING A SECURITY INVOLVED IN A "SECURITIES TRANSACTION", PROTECTED BY RULE 10 b-5 OR SECTION 17(a) TO PRECLUDE SUMMARY JUDGMENT IN THE BANK'S FAVOR.

(A) Elements Of A Private Claim Under The Federal Securities Acts:

A private cause of action is implied under Rule 10 b-5 for a party similarly situated as the Weavers. *See Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975). Private claims have also been implied under Section 17(a) of the 1933 Act. *Kirshner* v. *United States*, 603 F.2d 234, 241 (2nd Cir. 1978) *cert. denied*, 442 U.S. 909 (1979); *Newman* v. *Prior*, 518 F.2d. 97, 99 (4th Cir. 1975); *see generally* Hazen, *A Look Beyond the Pruning of 10(b)(5); Implied Remedies in Section 17(a) of the 1933 Act*, 64 Virginia Law Review 641, 648 (1978) (Footnote 35 and cases cited therein).[12]

[12] This issue was not addressed by the Court in *Aaron* v. *S.E.C.*, 446 U.S. 680, 689 (1980).

Face-to-face private securities transactions have been held to be within the scope of the protection of the anti-fraud sections of the Federal Securities Acts. *Matheson* v. *Armbrust,* 284 F.2d 670 (9th Cir. 1960), *cert. denied* 365 U.S. 870 (1961). The imposition of Rule 10 b-5 liability is not predicated on the transaction being conducted through a securities exchange or an organized national market. *Superintendent of Insurance* v. *Bankers Life & Casualty Co.,* 404 U.S. 6, 10 (1971).

The tenth Circuit in *Stevens* v. *Vowell,* 343 F.2d 374 (10th Cir. 1965), at page 378, summarized what a claimant must prove to establish a 10 b-5 claim, stating:

> It is, of course, the law that the burden is upon the plaintiff to establish jurisdiction, and coincidentally make out a case under the statute and rule and to do so he must prove: (1) use of the mails or instrumentalities of interstate commerce; (2) the purchase and sale of a security; and (3) the use of a manipulative or deceptive device.

Proof of a "manipulative or deceptive device" within the third element of *Stevens* v. *Vowell, supra,* must involve "(1) a misstatement or an omission, (2) of a material fact, (3) made with scienter, (4) on which the plaintiff relied, (5) that proximately caused his injury." *Huddleston* v. *Herman & MacLean,* 640 F.2d 534, 543 (5th Cir. 1981).

Rule 10 b-5 applies to both buyers and sellers of securities and those that aid and abet a purchase and sale; Section 17(a) is limited to sellers and aiders and abettors of sellers. *Crowell* v. *Pittsburgh & Lake Erie Railroad Company,* 373 F.Supp. 1303, 1311 (E.D. Pa. 1974). Scienter is required for a 10 b-5 violation, *Ernst & Ernst* v. *Hochfelder, supra,* Scienter is not required by Section

17(a), *Aaron* v. *S.E.C., supra.*[13] Rule 10 b-5 liability would extend to the Bank's purchase and sale, and secondary misconduct, with respect to the Columbus agreement and the CD. Section 17(a) liability would apply to the sale of the Columbus agreement and related secondary misconduct. If the two transactions are considered as one transaction, then these distinctions are not important. The District Court, in granting the Bank's motion for summary judgment, did not reach the following issues: (1) whether there was a misstatement or an omission of a material fact; (2) whether the statements were made with the required scienter; (3) whether channels of interstate commerce were affected; (4) whether the misstatements were made "in connection with" the purchase and sale of a security; and (5) whether there was any detrimental reliance by Weaver on the misrepresentations made by Marine.[14] There were sufficient facts in the record to preclude the District Court from granting summary judgment on those issues.

The District Court concluded that there was no genuine issue of a material fact as to whether the March 17, 1978 transaction made reference to above constituted a purchase and sale of a security and/or securities within either Federal Securities Act. Upon finding that there was no genuine issue of a material fact which would support a purchase and sale of a security within these Acts,

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[13] The Bank claims that the Weavers did not plead the requisite "scienter" in the complaint. This issue was never raised in the District Court or reviewed by the Third Circuit. Considering that Rule 9(b) of the F.R.C.P. does not require specific allegations regarding state of mind, the Weavers' complaint was sufficient. *Denny* v. *Carey*, 72 F.R.D. 574 (E.D. Pa. 1976).

[14] The Bank's brief, incorporated by reference as part of the District Court's Opinion, also failed to address any of these issues.

the Court ruled that a necessary jurisdictional element was lacking and dismissed the Weavers' case by holding that the Court lacked subject matter jurisdiction (PA-28).

(B) Standard Of Review For Considering The Propriety Of Granting Summary Judgment Pursuant To Rule 56 Of The Federal Rules Of Civil Procedure:

This case was decided by summary judgment pursuant to Rule 56(c) of the Federal Rules of Civil Procedure.[15] The Bank, as moving party, had the burden of proving that there were no genuine issues of material fact to support the Weaver's contention that there was a purchase and sale of a security as a consequence of the March 17, 1978 transactions. *United States ex rel. Jones* v *Rundle,* 453 F.2d 147 (3rd Cir. 1971).

If the facts and their inferences on the critical issues are disputed, after construing them most favorably in favor of the non-moving party, in this case, the Weavers, it is reversible error to grant summary judgment. *Adickes* v. *Kress & Company, Inc.,* 398 U.S. 144 (1970); *U.S.* v. *Diebold, Inc.,* 369 U.S. 654 (1962); *In Re: Consolidated Pre-Trial Proceedings In Antibiotic Antitrust Actions,* 538 F.2d 180 (8th Cir. 1976) *cert. denied,* 429 U.S. 1040 (1977).

Certain cases have traditionally been inappropriate for disposition by motions for summary judgment. *In Epprecht* v. *Delaware Valley Machinery, Inc.,* 407 F.Supp. 315 (E.D. Pa. 1976) a claim under 10 b-5, the Court discussed this burden at page 322, stating:

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[15] Rule 56(c) of the Federal Rules of Civil Procedure provides in part, ". . . the judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law."

> That burden (of proving the absence of a genuine issue of material fact) is especially heavy on a defendant who seeks summary judgment on the basis that a plaintiff has failed to create a genuine factual dispute as to such elusive concepts as motive, intent, conspiracy or knowledge. *Poller* v. *Columbia Broadcasting System, Inc.*, 368 U.S. 464, 82 S.Ct. 486, 7 L.Ed. 2d 458 (1962); *Adickes* v. *Kress & Company, Inc.*, 398 U.S. 144, 90 S.Ct. 1598, 26 L.Ed. 142 (1970).[16]

(C) The Columbus agreement to pay the Weavers 50% of the profits of Columbus could be found to be an "investment contract" or a "profit sharing agreement" or a "certificate of interest," and, therefore, a security within either of the Federal Securities Acts:

Columbus agreed, in writing, to grant the Weavers 50% of the "adjusted net profits" of Columbus.[17] This agreement was executed sometime between February 28, 1978 when the Weavers purchased their CD from the Bank and March 17, 1978 when the CD was pledged to the Bank.[18]

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[16] See discussion of summary judgment procedures in complex cases in *In Re: Consolidated Pre-Trial Proceedings in Antibiotic Antitrust Action*, 538 F.2d 184-185.

[17] That written agreement provided "2. While Piccirillo is operating and in possession of the Columbus Packing premises and until said $50,000.00 loan is paid in full by Piccirillo, Weaver shall have the following rights: . . . (b) to receive 50% of the 'adjusted net profits' of Columbus Packing Company at the conclusion of each fiscal year. The computation of the 'adjusted net profits' at the conclusion of each fiscal year shall be (1957) based on the percentage of days in the immediately preceding fiscal year during which Weaver was a co-obligor on the aforementioned indebtedness by Piccirillo" (JA-11).

[18] Sam Weaver described the purpose of the Columbus agreement, stating, ". . . It was a little share of the business, a little share of his profits in business, if he made any profits; he was giving us a little share in his business if we'd loan him a little working capital." (CA-319).

The Third Circuit, in reversing the District Court, held that there were genuine issues of material fact as to whether the Columbus profit sharing agreement was an "investment contract" with *S.E.C.* v. *Howey,* 328 U.S. 293 (1946) and *Tcherepnin* v. *Knight,* 389 U.S. 332 (1967), which precluded the grant of summary judgment under Rule 56 of the Federal Rules of Civil Procedure. Alternatively, the Court held that this agreement could be considered a "certificate of interest or participation in a profit sharing arrangement" (A-6) within the definition of a security under the Federal Securities Acts, citing *S.E.C.* v. *Addison,* 194 F.Supp. 709, 721-22 (N.D. Tex. 1961) and *William Tell Productions, Inc., S.E.C. Act. Rel.,* 3852 (1957). The definitions of security in the 1933 and 1934 Acts are virtually identical. *Tcherepnin* v. *Knight,* 389 U.S. 332, 342 (1967); *U.S. Housing Foundation, Inc.* v *Forman,* 421 U.S. 837, 847 (1975) (Footnote 12). The definitions include "investment contract," "profit sharing agreement," "certificate of interest" and "note." 15 USC § 77 b(1); 15 USC § 78 c(2)(10). The 1933 Act includes, as a security, "evidence of indebtedness," which term is not included in the 1934 Act.

Investment contract

An "investment contract," a form of a security within both statutory definitions, has been defined by the Court in *S.E.C.* v. *Howey, supra* at 298, 299, as:

> "(A) contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter of a third party, it being immaterial whether the share in the enterprise is evidenced by a formal certificate or by nominal interest in physical assets employed in the enterprise."

To meet the *Howey* test, an investment contract must involve an (1) investment of money or its equivalent; (2) in a common enterprise; (3) with the expectation of profits from the efforts of others. *Cameron* v. *Outdoor Resorts of America,* 608 F.2d 187, 192 (5th Cir. 1979); *Hector* v. *Wiens,* 533 F.2d 429, 432, 433 (9th Cir. 1976); *see also* FitzGibbon, *What is a Security? A Redefinition based upon the Eligibility to Participate in Financial Markets,* 64 Minn. L. Rev. 898-908 (1980).

(1) *Investment of money.* There is little doubt that, if the Weavers had given Columbus $50,000.00 in exchange for Columbus' agreement to grant 50% of the profits of Columbus to the Weavers, and it was understood between the parties that the $50,000.00 was for working capital, that the investment of money requirement for an investment contract would be satisfied. *S.E.C.* v. *Glenn Turner Enterprises, Inc.,* 474 F.2d 476 (9th Cir. 1973), *cert. denied,* 414 U.S. 82 (1973). A "substance-over-form" analysis must be applied in determining whether or not the requirement of an investment contract have been met. *S.E.C.* v. *Howey Co., supra* at 299; *Tcherepnin* v. *Knight, supra* at 336.

The Ninth Circuit in *Hector* v. *Wiens, supra* at 432 discussed the investment of money requirement of the *Howey* test and stated:

> . . ., an investment of money means only that the investor must commit his assets to the enterprise in such a manner as to subject himself to financial loss. *El Khadem* v. *Equity Securities Corp.,* 494 F.2d 1224 (9th Cir. 1974), *cert. denied,* 419 U.S. 900 (1974).

The execution of promissory notes in *Hector* v. *Wiens, supra* was found to constitute an "investment of money" within this requirement, *Id.* at 432. Considering that the Weavers' risk of loss of the CD was dependent upon the

success of Columbus, this pledge constituted an investment of money within the *Howey* test.

International Brotherhood of Teamsters v. *Daniel*, 439 U.S. 551 (1979) is clearly distinguishable from the present case. There a retirement fund was created out of contributions made by employers. The claim was that the retirement fund constituted a security. There was no specified amount of money or property which could have constituted an "investment in money" in the same fashion that the Weavers' CD was recognized by the Bank to be the Weavers' investment in Columbus. In holding that the retirement fund was not a security, the Court stated:

> In every decision of this Court recognizing the presence of a "security" the person found to have been an investor chose to give up a specific consideration in return for a separable financial interest.

Id. at 559-60. The Weavers pledged their CD for the right to receive 50% of the profits of Columbus (See Footnote 17).

(2) *Common enterprise.* The Ninth Circuit in *Hector* v. *Wiens, supra* at 433 held that vertical commonality is all that is required to satisfy the common enterprise element; and that horizontal commonality, or multiple investors, are not required for an investment contract.[19] A single investor and one promotor satisfies the commonality requirement. *S.E.C.* v. *Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974); *Rochkind* v.

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[19] See discussion of vertical and horizontal commonality in *Securities Investor Protection Corp.* v. *Associates Underwriters, Inc.*, 432 F.Supp. 168, 178 (D. Utah 1975); *Troyer* v. *Karcagi*, 476 F.Supp. 1142, 1147 (N.D. N.Y. 1979) (where a requirement of horizontal commonality is discussed and rejected as a necessary ingredient of a common enterprise within the *Howey* test.

Reynolds Securities, Inc., 388 F.Supp. 254 (D. Md. 1975) (and cases cited therein).

The contracts involving the delivery of commodities in the future, such as that in *Hirk* v. *Agri-Research Council, Inc.*, 561 F.2d 96 (7th Cir. 1977); *Milnarik* v. *M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir. 1972); and *Wasnowic* v. *Chicago Board of Trade*, 352 F.Supp. 1066 (M.D. Pa. 1972), are significantly different than the agreement between the Weavers and Columbus to share the profits of Columbus. The commodity speculator's chances of making a profit and the promotor's, or broker's chances of making a profit or commission are not dependent on each other or any other investor. The commodity speculator can lose money while the broker or the promoter, in this context, can make money. On the other hand, the Weavers' chances of making a profit were the same as Columbus' chances, which were dependent upon Columbus combining its assets and labor with the Weavers' working capital. The pooling of the Weavers' capital with Columbus' assets and labor satisfies the vertical commonality test and whatever, if any, horizontal commonality that is required for an investment contract.

(3) *Expectation of profits from the efforts of others.* To satisfy the third test of the *Howey* definition for investment contracts, the investor must expect profits from the efforts of others as a result of his investment. The Ninth Circuit in *S.E.C.* v. *Glenn Turner*, 474 F.2d 476, 482 (9th Cir. 1973), *cert. denied*, 414 U.S. 82 (1973), held that, so long as the promoter performed the "essential managerial" efforts, the third requirement for an investment contract was satisfied, even though the investor may be required to contribute labor or effort on behalf of the enterprise. If Columbus had produced a profit, it would have resulted largely from Piccirillo's efforts and

any contribution that the Weavers would have made, other than providing working capital, would have been slight considering their advanced age.

The Columbus agreement giving the Weavers a share of the profits, also gave the Weavers grazing rights.[20] Based on this provision and based on the Bank's suggestion that the Weavers had an expectation of getting some cattle auction business from Columbus in consideration for this agreement, the Bank contends that the Weavers were not expecting profits from the efforts of others within the *Howey* rule. Sam Weaver unequivocally testified that the consideration for the pledge to the Bank and the loan to Columbus, was a share in the Columbus business and profits. Because the Weavers are entitled to all of the favorable inferences in a motion for summary judgment, and because the Bank failed to offer any evidence whatsoever to quantify consideration, other than profits, received by the Weavers, the third element of the *Howey* test was satisfied.

Profit sharing agreement or certificate of interest

Besides finding that the Columbus agreement could be found to be an investment contract, the Third Circuit also found that the Columbus agreement could constitute a "certificate of interest or participation in any profit sharing agreement," both of which fall within the definition of security under the Federal Securities Acts. The Columbus agreement clearly represented an agreement between the Weavers and Columbus to share the profits of Columbus and was within the definition of prof-

[20] This agreement allowed the Weavers "to use the barn and pastures located in the Columbus Packing Company premises in Columbus Township, Warren County, Pennsylvania at the discretion of Piccirillo" (JA-11).

it sharing agreement. *S.E.C* v. *Addison*, 194 F.Supp. 709, 721-222 (N.D. Tex. 1961); *see also 1 Loss, Securities Regulation*, 489 (2d ed. 1961) (relied upon by the Third Circuit in arriving at this conclusion) (A-6).

The Court in *Crowell* v. *Pittsburgh & Lake Erie Railroad Company*, 373 F.Supp. 1303, 1309 (E.D. Pa. 1974), defined a certificate of interest, stating:

> In this case, the investors have provided financing for the purchase of cars in return for which they expect profits which result from Pittsburgh and Lake Erie efforts.

The Weavers provided working capital for Columbus through the Bank in consideration for what Weaver described as a "little share of his profits" (see footnote 18). A participation in a loan agreement with the expectation of profits is a security within the 1934 Act. *Lehigh Valley Trust Company* v. *Central National Bank of Jacksonville*, 409 F.2d 989 (5th Cir. 1969).

After construing the record facts most favorably to Weaver, as required by the applicable standard of review in a summary judgment proceeding, *U.S.* v. *Diebold, Inc.*, 369 U.S. 654 (1962), there were genuine issues of material fact that preclude a finding, as a matter of law, that the Columbus agreement was not an investment contract, a profit sharing agreement, or a certificate of interest within the definition of security in either the 1933 or 1934 Acts. The Third Circuit was correct in reversing the District Court and remanding this case to the District Court for further proceedings in accordance with its Opinion.

(D) There Were Genuine Issues Of Material Fact Regarding The Bank's Role With Respect To The Sale Of The Columbus Agreement To The Weavers Either Under A Theory Of Primary liability Or Under A Theory Of Secondary Liability, Thereby Precluding The Grant Of Summary Judgment In Favor Of The Bank.

The Weavers' claim against the Bank with respect to its liability for the Columbus agreement was twofold. First, the Bank's possession of all of the pertinent financial information of Columbus implicates the Bank either as an "insider" within *S.E.C.* v. *Texas Gulf Sulphur Company*, 401 F.2d 833 (2nd Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) or Columbus' "investment banker" as in *In Re: Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), thereby imposing primary liability for misrepesentations made in connection with inducing the Weavers to invest in Columbus.

The Weavers also claim that the Bank was secondarily liable as an "aider and abettor" within *Monsen* v. *Consolidated Dressed Beef Company, Inc.*, 579 F.2d 793, 800 (3rd Cir. 1978); RS 2d, Torts, § 876; *Zabriskie* v. *Lewis*, 507 F.2d 546, 533-4 (10th Cir. 1974); or secondarily liable as a "professional consultant" within *Crofoot* v. *Sperry Rand Corp.*, 408 F.Supp. 1154, 1157 (E.D. Cal. 1976); or "substantially involved" in the affairs of Columbus when making the misrepresentations to the Weavers calculated to induce their investment in Columbus. *Zweig* v. *Hearst Co.*, 594 F.2d 1261 (9th Cir. 1979).

The Bank claimed in the District Court, the Third Circuit Court of Appeals, and this Court that because it had no direct knowledge of the sale of the Columbus agreement to the Weavers this precluded imposition of either primary or secondary liability. The Third Circuit reversed the District Court's holding on this issue stating (A-9):

> "(A) fact finder could have found that the Bank engaged in material and deceptive acts or practices in connection with the purchase by Weaver of a contract for a 50% share in the profits of Columbus . . ."

The Weavers claimed that the Bank, having all of the inside financial information of Columbus and, therefore, having full knowledge of Columbus' insolvency, made material affirmative misrepresentations to the Weavers, individuals known to the Bank as potential investors in Columbus, for purposes of soliciting the Weavers to invest in Columbus through the Bank. The Bank intended to "enhance its position"[21] with respect to the Bank's outstanding loans and overdrafts of Columbus, as "enhancement" is described by the Third Circuit in a Rule 10 b-5 case against a bank in *Monsen* v. *Consolidated Dressed Beef Company, Inc., supra* at 803, footnote 17.

The Weavers are entitled to recision if the required elements of a 10 b-5 or 17(a) violation have been established. *Gordon* v. *Burr,* 506 F.2d 1080 (2nd Cir. 1974); *G & M, Inc.* v. *Newbern,* 488 F.2d 742 (9th Cir. 1973). As a purchaser and/or a seller of a security, the Weavers had standing to bring a claim under either Rule 10 b-5 or Section 17(a). *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723 (1975). Classifying the Bank as a seller is not a prerequisite to recognition of the Weavers' cause of action. The Second Circuit in *Bartege* v. *Barnett,* 553 F.2d 290, 291 (2nd Cir. 1977) stated:

> (T)he rule does not require that defendant be the seller of the stock or that plaintiff have purchased the stock from defendant.

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[21] A bankruptcy of Columbus in March, 1978 would have relegated the Bank to an unsecured creditor status. The pledge of the CD by the Weavers allowed the Bank to "enhance its position" and usurp a priority over other secured and priority liens (see footnote 6).

The Ninth Circuit had previously addressed this question in *G & M, Inc.* v. *Newbern*, 488 F.2d 742, 745 (9th Cir. 1973), and held:

> A plaintiff who is induced to buy or sell stock as a result of misrepresentations made by someone not a party to the sale may sue that person for damages incurred as a result of the sale . . .

When a bank actively attempts to secure investment capital for one of its customers it is acting in the capacity of an "investment banker." *In Re: Cady, Roberts & Co.*, 40 S.E.C. 907, 913 (1961). When an investment banker makes affirmative material misrepresentations to a potential investor and these material misrepresentations cause the sale of a security, liability is imposed under the Federal Securities Acts. *Id.; Ross* v. *Licht*, 263 F.Supp. 395 (S.D. N.Y. 1967). Considering the Bank's role in Columbus in its entirety, and construing the facts most favorably toward the Weavers', a fact finder could find that the Bank was acting as an "insider" within *S.E.C.* v. *Texas Gulf Sulphur Company*, 401 F.2d 833 (2nd Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); or an investment banker within *In Re: Cady, Roberts & Co., supra.*

Liability has been imposed against a wide range of professional consultants who, while in possession of inside information of a client, made material misrepresentations to third parties involved in a purchase and sale of a security or an investment transaction with that customer.[22]

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[22] Liability has been imposed against a lawyer; *Katz* v. *Amos Treat & Co.*, 411 F.2d 1046 (2nd Cir. 1969); against accountants, *Heit* v. *Weitzen*, 402 F.2d 909 (2nd Cir. 1968); *Spectrum Financial Company* v. *Marconsult*, 608 F.2d 377 (9th Cir. 1979); and against banks, *Carroll* v. *First National Bank of Lincolnwood*, 413 F.2d 353 (7th Cir. 1969). A bank was found liable as an aider and abettor in *Monsen* v. *Consolidated Dressed Beef Company, Inc.*, 579 F.2d 793, 800 (3rd Cir.

The courts in imposing secondary liability in security transactions have not limited liability to aiders and abettors, as those terms are defined in *Monsen* v. *Consolidated Dressed Beef Company, supra* at 800. Secondary liability under 10 b-5 has been imposed upon a party acting as a co-conspirator in *Ferguson* v. *Omnimedia, Inc.*, 469 F.2d 194 (1st Cir. 1972). *In Zabriskie* v. *Lewis*, 507 F.2d 546, 553-54 (10th Cir. 1974), the Tenth Circuit stated:

> The words acting in concert would indicate a finding of participation of multiple actors and liability imposed on participants if their participation is substantial.

Liability could be imposed against the Bank in the present case as a "mutual actor" as in *Crofoot* v. *Sperry Rand Corp.*, 408 F.Supp. 1157 (E.D. Cal. 1976).

The Weavers suggest that a pragmatic approach to the identification of a party secondarily liable for material misrepresentations made in connection with the purchase and sale of a security is the "flexible duty" standard developed by the Ninth Circuit in *White* v. *Abrams*, 495 F.2d 724, 730-1 (9th Cir. 1974).[23]

1978). A bank acting as a professional consultant and involved in the solicitation of capital was found liable to a farmer in closely similar circumstances as the present case. *Hector* v. *Wiens*, 533 F.2d 429 (9th Cir. 1976).

[23] The Ninth Circuit in *Zweig* v. *Hearst Company*, 594 F.2d 1261, 1268 (9th Cir. 1979) summarized the important factors in determining the disclosure duty under Rule 10(b)-5 as:

> (1) the relationship of the defendant to the plaintiff; (2) defendant's access to the information as compared to that of the plaintiff; (3) defendant's benefit derived from the relationship; (4) defendant's awareness of whether plaintiff was relying on the relationship in making his or her investment decisions; and (5) defendant's activities in initiating the transaction. Scienter is also required. *Id.* at 1268, footnote 13.

There were genuine issues of a material fact which would preclude the entry of summary judgment in the Bank's favor applying the "flexible duty" standard. First, the relationship of the Bank to the Weavers was that part of a purchaser and seller of a CD and that of a potential investor in Columbus and an insider of Columbus. Secondly, the Bank had access to all of the financial information of Columbus and the Weavers had none. Thirdly, the Bank derived great benefit from a sale of an investment interest in Columbus to the Weavers as this allowed the Bank to "enhance its position" and secure a loan which was previously unsecured and correct a continuing overdraft problem it had with Columbus. Fourthly, the Bank was fully aware that it had superior information with respect to Columbus, and that the Weavers were relying upon the Bank for advice on their "investment" decision and to continually monitor the financial affairs of Columbus thereafter. Lastly, the Bank actively and frequently solicited the Weavers to engage in this transaction.

The Bank claims it lacks specific "knowledge" of the Columbus profit sharing agreement preventing a finding that it is either primarily or secondarily liable for the purchase and sale of that agreement. Corporate knowledge of the Columbus agreement by the Bank could be inferred from the circumstantial evidence developed at a full trial. *See Securities and Exchange Commission* v. *Coffey,*

Previously the Ninth Circuit in *White* v. *Abrams, supra* at 736, discussed the rationale for the "flexible duty" standard stating:

> Where the defendant derives great benefit from a relationship of extreme trust and confidence with the plaintiff, the defendant knowing that plaintiff completely relies upon him for information to which he has ready access, the law imposes a duty upon the defendant to use extreme care in assuring that all material information is accurate and disclosed. If the defendant has breached this duty he is liable under Rule 10(b)-5 provided the elements of materiality, causation and damages are established.

493 F.2d 1304, 1317 (6th Cir. 1974). Construing the facts and inferences most favorably to the Weavers, an inference can be drawn that the Bank recognized the Weavers as "investors" who were given consideration by way of a share of the profits and business of Columbus as a consequence of their agreement to pledge their $50,000.00 CD for this purpose.

The First Circuit in *Ferguson* v. *Omnimedia, Inc., supra* at 196-7 reversed a District Court's grant of summary judgment, where the District Court held that a party charged as a co-conspirator or as an aider and abettor in a securities violation knew of a balance sheet which was the subject matter of that case. The First Circuit held there was sufficient circumstantial evidence to allow a finding that the defendant had knowledge of the balance sheet. More importantly, the Court held that where the issue of knowledge is largely based upon circumstantial evidence and the facts are largely within the control of the moving party, summary judgment is inappropriate and not a "sufficient substitute for trial." *Id.* at 198.

Other courts in Federal Securities Acts cases have found the requisite guilty knowledge to impose secondary liability from the totality of the circumstances. *Trussel* v. *Underwriters Ltd.*, 228 F.Supp. 757 (D. Colo. 1964); *Brennan* v. *Midwestern United Life Insurance Company,* 259 F.Supp. 673 (N.D. Ind. 1966), 286 F.Supp. 702 (N.D. Ind. 1968), *aff'd* 417 F.2d 147 (7th Cir. 1969), *cert. denied* 397 U.S. 389 (1970).

The Weavers claim there are genuine issues of material fact as to whether the Bank was acting as an "insider" of Columbus within *S.E.C.* v. *Texas Gulf Sulphur,* 401 F.2d 833 (2nd Cir. 1968), *cert. denied* 394 U.S. 976 (1969); or like Columbus' "investment banker" within *In Re: Cady, Roberts & Co.*, 40 S.E.C. 907 (1961); or as an

"aider and abettor" to Columbus' sale of this agreement, *Monsen* v. *Consolidated Dressed Beef Company, Inc.*, 579 F.2d 793 (3rd Cir. 1978); or liable under any of the theories of secondary liability such as a "professional consultant" or "mutual actor" as those terms are defined in *Crofoot* v. *Sperry Rand*, 408 F.Supp. 1157 (E.D. cal. 1976). Applying the Ninth Circuit's "flexible duty" standard in *White* v. *Abrams*, 495 F.2d 724 (9th Cir. 1974), there are genuine issues of material fact to support the contention that the Bank was "substantially involved" in Weavers' investment transaction in Columbus so as to impose liability under this standard.

(E) There Were Genuine Issues Of Material Fact As To Whether The Weavers' Pledge Of Their CD Was A "Securities Transaction" And, Therefore, A Purchase And Sale Of A Security Within The Anti-Fraud Provisions Of The 1933 or 1934 Acts To Preclude This Issue From Being Resolved By Way Of Summary Judgment.

The District Court held, as a matter of law, that the CD which the Weavers pledged to the Bank on March 17, 1978 was not a security within either the 1933 or 1934 Acts.[24] In granting summary judgment, the District Court held (PA-28):

> The transaction was nothing more than an ordinary commerical transaction entered into by borrowers and co-obligors such as the Weavers with security given the lender by one of the co-obligors, that is the Weavers, the plaintiff in this case.

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[24] The Weavers' claim with respect to the CD and the application of Section 17(a) was properly and timely raised in the Weavers' answer to the Bank's motion for summary judgment, and contrary to the Bank's assertion, the District Court considered the Weavers' Certificate of Deposit claim under Section 17(a) on its merits (See footnote 2).

The Third Circuit, in addition to its holding that there were fact issues as to whether the Columbus agreement was an investment contract, held that there were issues relating to this CD which precluded a finding, as a matter of law, that it was not a security or part of a securities transaction within the 1934 Act. The Third Circuit held that a pledge of a CD constituted a sale, citing *Mallis* v. *F.D.I.C.*, 568 F.2d 824, 829-30 (2nd Cir. 1977), *cert. dismissed sub nom, Bankers Trust Company* v. *Mallis*, 435 U.S. 381 (1978) (PA-10). The Third Circuit correctly predicted that this Court would hold that a "pledge" constituted a purchase and sale of a security as the terms "purchase and sale" are used in the 1933 and 1934 Acts. *Rubin* v. *U.S.*, ___ U.S. ___, 100 S.Ct. 698 (1981).

The Weavers' six year CD, having a maturity in excess of nine months, was, according to the Third Circuit, ". . . in all material respects . . . (the) functional equivalent of any other corporation's bond or note . . ." and thus, the Court stated that, ". . . we cannot on this record hold that a certificate of deposit evidencing its debt is not, like other long term bonds or notes, a security," (PA-12). The Third Circuit followed the direction of the Fifth Circuit in *Bellah* v. *First National Bank of Hereford*, 495 F.2d 1109 (5th Cir. 1974)[25] and remanded this matter to the District Court ". . . so as not to foreclose them from an opportunity to pursue that theory of liability in the District Court." (PA-12).

The protection afforded by the 1933 and 1934 Acts is remedial. It is not focused on "securities" in the abstract. Rather, it is designed to protect "investors" from trading

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[25] *Bellah* has been cited by the Bank for the proposition that a CD is not a security. However, the Comments of the *Bellah* Court on the CD issue were dicta and the case was remanded to allow the plaintiffs to pursue the CD theory, *Id.* at 1116.

in securities in reliance upon material misrepresentations and the manipulative and deceptive devices of others. As stated by this Court in *United States Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 849 (1975): "The need for regulation to prevent fraud and to protect the interests of investors" was the purpose of this legislation. The Second Circuit previously stated that, "The act is for the protection of investors and its provisions must be read accordingly." *Movielab, Inc.* v. *Berkey Photo, Inc.*, 321 F.Supp. 806 (S.D. N.Y. 1970) (corporate notes were held to be securities because, in part, they evidenced an investment); *Zeller* v. *Bogue Electric Mfg. Co.*, 476 F.2d 795 (2nd Cir. 1973) (corporate demand note was found to be a security).

The definition of security within the context of either the 1933 or 1934 Act should be subordinate to identifying an investor making an investment transaction or "securities transaction." As the Court cautioned in *United States Housing Foundation, Inc.* v. *Forman, supra* at 849, a "literal approach" should not be followed in defining security; rather, the "economic realities underlying a transaction" should be examined for the purpose of affording protection to an investor making an investment transaction against misrepresentations and manipulative devices used by others to induce such a transaction. The Court in *Forman, supra* at 859-860, identified those who are entitled to the protection of these Acts, stating:

> What distinguishes a "securities transaction" — what is absent here — is an investment where one parts with his money in the hopes of receiving profits from the efforts of others.

A six year CD issued by a bank is literally "any note" or "evidence of indebtedness" within these terms as

used in the definition of security in the 1933 Act, or "any note" as that term is used in the 1934 Act.[26]

In holding that a CD or a bank time deposit having a maturity date greater than nine months is a security within either the 1933 or 1934 Acts, the Third Circuit did not break new ground. The District Court found a CD to be a security in *Garner* v. *Pearson*, 374 F.Supp. 591, 596 (M.D. Fla. 1974). Likewise, the District Court in *Superintendent of Insurance of State of New York* v. *Bankers Life & Casualty Co.*, 300 F.Supp. 1083, 1100 (S.D. N.Y. 1969), *rev'd on other grounds*, 404 U.S. 6 (1971), held that a CD could be a "note" within either Act or "evidence of indebtedness" within the 1933 Act.[27] Applying the "commercial-investment dichotomy," the Fifth Circuit found that time certificates of deposit issued by a Bahamian Bank and sold by the Bank of Miami were arguably securities in *Meason* v. *Bank of Miami*, ____ Fed.2d ____ (5th Cir., August, 1981); *but cf. Ayala* v. *Jamaica Savings Bank*, ____ F.Supp. ____ (E.D. N.Y. 1981) (where the court held that the *issuance* of a time deposit was not a security or a "securities transaction").

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[26] The Third Circuit did not hold that this CD was a security because it fell within the phrase "certificate of deposit, for a security," even though there is authority to support that contention. Because this CD's maturity date substantially exceeds nine months, it does not qualify for the exception in the 1934 Act which states, "but shall not include currency or any note, draft, bill or exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months . . ."

[27] Related holdings were made in *Securities and Exchange Commission* v. *First American Bank & Trust Co.*, 481 F.2d 673 (8th Cir. 1973) (capital notes, certificates of investment and passbook savings accounts of a state-regulated bank); *Young* v. *Seaboard Corp.*, 360 F.Supp. 490 (D. Utah 1973) (savings accounts and certificates of deposit of a bank); *MacKethan* v. *Peat, Marwick, Mitchell & Co.*, 439 F.Supp. 1090 (E.D. Va. 1977) (certificates of investment in industrial loan bank).

The Bank and the American Bankers Association argue that any CD issued by a F.D.I.C. bank is exempt from being a security within either the 1933 or 1934 Acts, irrespective of its being traded for investment purposes in a secondary transaction. For the most part, their position is represented by the thinking of the Court in *Ayala* v. *Jamaica Savings Bank, supra.* The United States, on the other hand, concedes that a CD is within the literal definition of security of either Act and that there are transactions where a CD would be a security and protected by 10 b-5 and 17(a) but in the "context" of this case, the Weavers' CD was not such a security.

The Weavers claim that there are transactions where CDs are purchased and sold for investment in secondary transactions after issuance, which are "securities transactions" within *United States Housing Foundation* v. *Forman,* 421 U.S. 837 (1975). Applying a transactional analysis to this case, it could be found that the Weavers were investing risk capital in Columbus by way of their pledge to the Bank with the expectation of profits as the consideration for their pledge. The Bank's alleged lack of knowledge of the Columbus agreement and the fact that the Weavers had an expectation of profits, are facts to be considered with many others in determining whether the Bank is liable for material misrepresentations in connection with a "securities transaction," but not whether, in the first instance, there is a protected "securities transaction."

No Circuit Court has formulated a "litmus test" as to when a transaction involving a CD corporate note, or similar debt instrument is a purchase and sale of a security. *In Lino* v. *City Investing Co.,* 487 F.2d 689 (3rd Cir. 1969), the Third Circuit stated: ". . . (t)he courts will have to consider the complete context of each transaction" to make this determination, 487 F.2d at 696,

footnote 5. In an issuance case — not presenting the issue of a secondary transaction, as in the instant action — the First Circuit advised that "the paramount concern in the inquiry is upon the nature of the transaction in which the note is issued." *S.E.C.* v. *Continental Commodities,* 497 F.2d 516, 525 (5th Cir. 1974). The Second Circuit has indicated that when the maturity of the debt instrument falls literally within the definition of a security which exceeds nine months, the burden is upon the party claiming that the debt instrument is not a security to prove that the context of the transaction was not a "securities transaction." *Exchange National Bank* v. *Touche Ross & Co.,* 544 F.2d 1126, 1137-38 (2nd Cir. 1976).

Debt instruments traded for purposes of providing capital for a new business were found to be securities in *Movielab, Inc.* v. *Berkey Photo, Inc.,* 321 F.Supp. 806 (S.D. N.Y. 1970), *aff'd,* 452 F.2d 622 (2nd Cir. 1971). Likewise, the Court has held that a note was a security in *Barthe* v. *Risso,* 384 F.Supp. 1063 (S.D. N.Y. 1974). Where notes are issued on the basis of inadequate collateral which materially affects the risk to the note holder, the sale is a security transaction protected by the Federal Securities Acts. *El Khadem* v. *Equity Securities Corp.,* 494 F.2d 1224 (9th Cir. 1974); *Lehigh Valley Trust Company* v. *Central National Bank of Jacksonville,* 409 F.2d 989 (5th Cir. 1969).

A secondary sale of certificates of deposit where the inducement was the payment of a small fraction of interest over the interest called for in the CD has been held to be a purchase and sale of a security. *Safeway Portland Employees Federal Credit Union* v. *C.H. Wagner & Co., Inc.,* 501 F.2d 1120 (9th Cir. 1974). The Ninth Circuit in *Great Western Bank* v. *Kotz,* 532 F.2d 1252, 1258 (9th Cir. 1976), identified multiple factors, such as maturity time, collateralization, and risk to be considered in determin-

ing whether a loan transaction is an investment transaction; there are sufficient facts in the present case to satisfy this standard and allow the Court to hold that the Weaver transaction would be considered an investment transaction.[28]

There is evidence that the issuance of the CD to the Weavers on February 28, 1978 was part of the process whereby the Weavers invested in Columbus because of the solicitations by Columbus and the Bank prior to that date. The Weavers' pledge on March 17, 1978 was intended by the Weavers to achieve an investment position in Columbus to obtain a "little share of the business" and a "little share of his profits." The Bank was fully aware that the Weavers were acting as "investors" in Columbus by pledging their CD. The Bank was fully aware that the purpose of this transaction was to generate capital to resuscitate the failing business of Columbus, and, as such, similar to the purpose underlying the security transaction in *S.E.C.* v. *Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974).[29]

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[28] Under analogous circumstances, a secondary investment transaction involving a certificate of deposit issued by a bank was found to be an investment contract within *S.E.C.* v. *W.J. Howey Co.*, 328 U.S. 293 (1946). *Swank Federal Credit Union* v. *C.H. Wagner & Co., Inc.*, 405 F.Supp. 385, 389 (D. Mass. 1975).

[29] As John Daggett, the Bank officer having the most contact with the Weavers and Columbus with respect to this transaction, stated: ". . . Without capital, without any money put into this business it really would not be able to exist very much longer, Tony needed to have capital in the business (CA-135) . . ." capital had to be injected in the business, something had to be done to bring this thing around. Tony came to me with an investor, that investor being Sam Weaver (CA-130) . . . well, in general, that he (Piccirillo) had someone who may be interested in investing in his business and that person was Sam Weaver (CA-133, 134). . . .If the loan could be restructured under the proper amount of money being invested, that Marine

Authorities relied upon by the Bank, such as *Canadian Imperial Bank of Commerce Trust Company* v. *Fingland*, 615 F.2d 465 (7th Cir. 1980); *Burrus, Cootes & Burrus* v. *MacKeithan*, 537 F.2d 1262 (4th Cir. 1976), *withdrawn as moot*, 545 F.2d 1388 (4th Cir. 1976), *cert. denied*, 434 U.S. 826 (1977); *Bellah* v. *First National Bank of Hereford, Texas*, 495 F.2d 1109 (5th Cir. 1974); and *Ayala* v. *Jamaica Savings Bank*, ___ F.Supp. ___ (E.D. N.Y. June, 1981), all relate to the *initial* issuance of a CD (similar to the first part of the transaction in this case when the Weavers' CD was issued by the Bank on February 28, 1978.) With respect to issuance, those courts rejected the concept that the initial issuance constitutes an "investment contract" within the definition of a security because there is no expectation of profits within *S.E.C.* v. *W.J. Howey, supra*, and the risk, if any, is minimal. But *none* of these cases involve a *secondary* pledge or sale of a CD where the sale or pledge, like the Weavers' was providing risk capital in consideration for the expectation of profits.

A note whose purpose is to generate risk capital constitutes a securities transaction protected by Rule 10 b-5 or Section 17(a) if it is given to revive a failing business. *S.E.C.* v. *Continental Commodities Corp., supra.* Misrepresentations as to collateralization of a long term loan which changed the character of the loan from one that was relatively safe to one having substantial risk have been found to involve 10 b-5 liability in connection with

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would be willing (to loan Piccirillo some money) to do this, yes (CA-147) . . . My conversation with him was very general in his (Weaver) investment and what collateral he (Weaver) could use (CA-14) . . . I tried to explain to him (Weaver) to the best of my ability the various ways that (Weaver) could become involved in the loan if he wanted to . . . and that is he came down to the dollar amount, the cash amount, by bringing in the Certificate (the $50,000.00 CD). (CA-131).

an investment transaction. *El Khadem* v. *Equity Securities Corp., supra.* The Weavers were providing risk capital within the standards set forth by the Ninth Circuit in *Great Western Bank & Trust* v. *Kotz,* 532 F.2d 1252 (9th Cir. 1976), and this three-way transaction, considered in its entirety, constituted a securities transaction similar to those in *Hector* v. *Wiens,* 533 F.2d 429 (9th Cir. 1976) and *Safeway Portland Employees Federal Credit Union* v. *C.H. Wagner & Co., Inc.,* 501 F.2d 1120 (9th Cir. 1974).

The Weavers' six year CD was literally within the definition of a security in either the 1933 or 1934 Acts. The secondary transaction of the Weavers' pledge of their CD to the Bank on March 17, 1978 was an investment or securities transaction because the Weavers were, in effect, providing risk capital to Columbus with an expectation of profits. The Bank made several material misrepresentations to the Weavers which gave them the illusion that this transaction was relatively safe when, in fact, it was fraught with risk. There were genuine issues of material fact relating to whether this pledge was the purchase and sale of a security in a securities transaction which preclude the grant of summary judgment in favor of the Bank on this theory of liability.

II. EVEN IF IT SHOULD FIND NO PURCHASE AND SALE OF A SECURITY WITHIN THE FEDERAL SECURITY ACTS, THIS COURT SHOULD REMAND THIS CASE TO THE DISTRICT COURT SO THAT THE DISTRICT COURT CAN RESOLVE THE PENDENT STATE CLAIMS IN ACCORDANCE WITH THE ORDER OF THE THIRD CIRCUIT COURT OF APPEALS.

The District Court, in dismissing the federal claims, also dismissed the state claims premised upon Pennsylvania law under Counts Two and Three of the Weavers' complaint. In doing so, the District Court relied upon the

holding of *Lentino & Flame* v. *Fringe Employee Plans, Inc.*, 611 F.2d 474 (3rd Cir. 1979). It concluded that because it found no purchase and sale of a security within the Federal Acts, and because there was no diversity of citizenship between the parties, it lacked jurisdiction to resolve the claims premised on Pennsylvania law (PA-27, 28). The Third Circuit reversed the District Court's dismissal of the claims premised on Pennsylvania law and held that there were compelling reasons why the District Court should resolve the state claims in one proceeding (PA-13 - 15).

The Weavers claimed that the actions and misrepresentations of the Bank giving rise to the claims under Rule 10 b-5 and Section 17(a) also gave rise to claims under the Pennsylvania Securities Act and Pennsylvania common law. The Pennsylvania Securities Act provides for a private action for recovery of damages for material misrepresentations in connection with a purchase and sale of a security. See 70 Purdons Stat. Ann. §1-501 (1980). The Acts' anti-fraud provisions are similar to those at Rule 10 b-5 and Section 17(a) of its federal counterparts. The state Acts' definition of an "insider" is similar to that which has evolved under federal case law. See 70 Purdons Stat. Ann. §1-401 (1980).

Pennsylvania common law provides for a private recovery for fraud and deceit. *See generally, Shane* v. *Hoffman*, 227 Pa. Super 76, 324 A.2d 532 (1974); *see also United Insurance Company of America* v. *B.W. Rudy, Inc.*, 42 F.R.D. 398 (E.D. Pa. 1967) (where the Court summarizes the elements of a fraud and deceit claim). Outside of the necessity of proving an effect on interstate commerce, and that a purchase and sale of a security was made within the definition of security of the Federal Acts, the proof underlying the claims set forth in Counts

Two and Three was the same as that required in proving a cause of action under Rule 10 b-5 or Section 17(a).

The Bank, in their petition for certiorari to this Court, and in their supporting brief, never raised the pendent jurisdiction issue. Therefore, the Third Circuit's resolution of that issue favorable to the Weavers is not before the Court at the present time. Rule 23(c), Supreme Court Rule. *In Whirlpool Corp.* v. *Marshall,* 445 U.S. 1 (1980) at page 161, Footnote 10, this Court recently stated:

> In its petition for certiorari, the petitioner did not cite this aspect of the Court of Appeals' decision as raising a question for review. Accordingly, the issue of whether the regulation covers the particular circumstances of this case is not before the Court. Sup. Ct. R. 23(c); *General Pictures Co.* v. *Electric Co.,* 304 U.S. 175, 177-179, 82 L.Ed. 1273, 58 S.Ct. 849.

Even if this Court would choose to review the Third Circuit decision on the pendent jurisdiction issue, it should conclude that the Court of Appeals correctly decided that issue in the context of this case. The general rule is that when there is one cause of action based upon two grounds, one federal and one state, the federal court shall retain jurisdiction to hear the related state claims if the federal claim was not plainly wanting of substance when it was filed. *United Mine Workers of America* v. *Gibbs,* 383 U.S. 715 (1966). Even though the federal claim may be resolved prior to trial, the Courts have held that the federal court has jurisdiction to resolve the related state law claims if, at the time of the filing, the federal claim was not plainly lacking in substance or "insubstantial." *Borror* v. *Sharon Steel Company,* 327 F.2d 165 (3rd Cir. 1964).

In Hagans v. *Levine,* 415 U.S. 528, 536 (1974), this Court previously indicated:

> the question may be plainly insubstantial either because it is obviously without merit or because its unsoundness so clearly results from the previous decisions of this Court as to foreclose the subject and leave no room for the inference that the question sought to be raised can be the subject of controversy.

The Weavers' claim, when filed, was a "substantial" claim within *Hagans* v. *Levine, supra,* for the following reasons: (1) there was, at best (from the Bank's point of view), a disparity of opinion between the various Courts as to whether a note or certificate of deposit is a security within the Federal Securities Act; (2) the Columbus agreement was unique; and (3) there was a lack of any prior Court decisions indicating that these instruments were not securities.

Once a federal court exercises jurisdiction to decide a case, as the District Court did in the present action in deciding this case on summary judgment, any dismissal which it renders is a dismissal on the merits and not a dismissal for lack of jurisdiction. *Bell* v. *Hood,* 327 U.S. 678 (1946). When the court exercises jurisdiction to decide the case on the merits, all of the closely related state law issues should be resolved by the federal court in one proceeding. *Rosado* v. *Wyman,* 397 U.S. 397, 404-5 (1970).

In Kavit v. *A.L. Stamm & Company,* 491 F.2d 1176 (2nd Cir. 1974), the Second Circuit affirmed the District Court's resolution of state law claims on the basis of pendent jurisdiction after the related federal securities claims had been dismissed prior to trial. Factors which the Second Circuit considered important included: (1) the substantial time period between the time the case was filed and the time a motion was submitted to dismiss the federal claim; (2) the amount of time that the parties had invested in the case; (3) whether the determination of the federal claim involved a significant federal issue; (4)

whether there would be a savings of substantial energy to the parties; and (5) whether it was convenient and fair to the litigants to resolve the state law claim in the federal forum. *Id.*, at 1180, footnote 4-5.

The exercise of pendent jurisdiction is discretionary. There was no indication in the District Court Opinion or upon the record that the District Court exercised any discretion in dismissing the Weavers' state claims. The District Court apparently concluded that once the underlying federal claim was dismissed, it not longer possessed jurisdiction to resolve the merits of the state court claims, even though *Bell* v. *Hood*, 327 U.S. 678 (1946), clearly holds to the contrary.

All the necessary pendent jurisdiction criteria set forth by the Court in *Kavit* v. *A.L. Stamm & Company, supra,* were met in this case. The District Court should have exercised its pendent jurisdiction over the Weavers' state law claims.[30]

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[30] The Bank filed its motion for summary judgment a few weeks prior to the scheduled jury trial. The Weavers had already invested two years preparing for a trial on all issues in federal court (i.e., May, 1979-December, 1980). The determination of the supporting federal securities claims and, specifically, the CD issue, involves a significant federal issue. Substantial judicial energy would be saved by resolving these claims in one forum. Considering the Weavers' advanced age and the backlog of civil cases in the Court of Common Pleas of Erie County, there is a substantial chance that any claim in that Court would not be resolved in the foreseeable future. Further, the Weavers instituted action in that Court against the Bank (at Civil Action Nos. 3308-A-1979 and 3325-A-1979) by way of a summons which was not served in reliance upon the federal court resolving the entire controversy. Any further prosecution of this claim in state court now may well be barred by a two year statute of limitation, 42 Pa.C.S.A. 5524, because the Bank was not served with the initial writ of summons.

In dismissing the claims premised on Pennsylvania law, the District Court relied upon *Lentino* v. *Fringe Employee Plans, Inc.*, 611 F.2d 474 (3rd Cir. 1979). There, however, the Court *affirmed* the District Court's exercise of pendent jurisdiction after the federal claim had been dismissed. The Court justified the exercise of pendent jurisdiction under those circumstances in "the interests of convenience and judicial economy," *Id.*, at 480.

Irrespective of what conclusion this Court makes as to the Columbus agreement or the CD being a security under the Federal Securities Acts, this Court should remand the case to the District Court — as opposed to dismissing it entirely — so that the District Court can resolve the Weavers' claims premised on Pennsylvania law.

The Third Circuit's decision that the District Court erred in dismissing the pendent state law claim is not before the Court because the Bank failed to raise this issue in its petition for certiorari. *Whirlpool Corp.* v. *Marshall*, 445 U.S. 1 (1980); Rule 23(c), Supreme Court Rules. Even if this Court would review the pendent jurisdiction issue, it should find that the Third Circuit Court of Appeals was correct in reversing the District Court and holding that the District Court had pendent jurisdiction over the Weavers' claim premised upon Pennsylvania law and that the circumstances of this case dictate that the District Court should exercise its jurisdiction to resolve these claims on their merits. *Rosado* v. *Wyman*, 397 U.S. 397 (1970); *Borror* v. *Sharon Steel Company*, 327 F.2d 165 (3rd Cir. 1964); and *United Mine Workers* v. *Gibbs*, 383 U.S. 715 (1966).

CONCLUSION

This Court should affirm the Order of The Third Circuit Court of Appeals reversing the grant of summary judgment in favor of the Bank. There were genuine is-

sues of material fact as to whether the Columbus profit sharing agreement with the Weavers was an "investment contract," a "profit sharing agreement" or a "certificate of interest" within the definition of a security under either the 1933 or 1934 Acts sufficient to preclude that issue from being resolved on summary judgment.

The additional holding that the Weavers' six year certificate of deposit was a security within these Acts should also be affirmed. The CD was literally within the definition of security and not excluded by any exemption. Its pledge in this secondary transaction involved investment-type risk to the Weavers made for the expectation of profits.

Irrespective of this Court's conclusion as to the Columbus agreement and the Weavers' certificate of deposit being securities, the Court should remand the case to the District Court so that the District Court can resolve the Weavers' claims against the Bank under Pennsylvania law in accordance with the Third Circuit's Opinion and Order that the District Court had pendent jurisdiction over these claims and should exercise that jurisdiction to resolve these claims on their merits. In addition to the controlling federal law on this issue, this result is warranted because of the Third Circuit's decision and because the pendent jurisdiction issue was neither challenged nor presented to this Court for review by the Bank.

Respectfully submitted,

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